

Unrelated debt-financed income; leases of historically or architecturally significant buildings. Buildings, acquired through assumption of outstanding mortgages by an exempt organization that restores, preserves, and exhibits buildings of historical and/or architectural significance, constitute debt-financed property within the meaning of section 514(b)(1) of the Code when they are leased at fair rental value for uses that neither bear any relationship to the buildings' historical or architectural significance nor accommodate viewing by the general public.

Advice has been requested whether property acquired and used in the manner described below constitutes debt-financed property within the meaning of section 514(b)(1) of the Internal Revenue Code of 1954.

'An organization that is exempt from Federal income tax under section 501(c)(3) of the Code was formed to promote the appreciation of history and architecture by acquiring, restoring, and preserving buildings of historical and/or architectural significance. In most instances, the organization opens the restored buildings to the general public for a nominal admission fee. By carrying on its activities in this manner, the organization is operating for educational purposes essentially in the same manner as a museum.

Occasionally, the organization acquires an historically or architecturally significant building by assuming an outstanding mortgage on the property as a part of the purchase price. Some of the buildings that are acquired in this manner are leased for uses that neither bear any relationship to the building's historical or architectural significance nor accommodate viewing by the general public.

'Rent charged by the organization for these buildings generally conforms with the fair market value of the particular building and is sufficient to recover the cost of purchase, restoration, and maintenance, and generate net income for use in the organization's exempt functions. All leases by the organization are made subject to restrictive covenants to insure that the historical architecture of the buildings is maintained by the lessee.

'Section 514(b)(1) of the Code defines the term 'debt-financed property' which is held to produce income and with respect to which there is an acquisition indebtedness as defined in section 514(c).

'Section 514(c)(2)(A) of the Code provides that the term 'acquisition indebtedness' includes property acquired subject to a mortgage or other similar lien.

'Section 514(b)(1)(A)(i) of the Code excludes from the definition of debt-financed property any property substantially all the use of which is substantially related (aside from the need of the organization for income or funds) to the exercise or performance by such organization of the purpose or function constituting the basis for its exemption.

'Section 1.514(b)-1(b)(1) of the Income Tax Regulations provides that, in determining whether the exclusion set forth in section 514(b)(1)(A)(i) of the Code is applicable, the principles in section 1.513-1 should be applied in determining whether there is a substantial relationship between the property and the exempt purpose of the organization.

'Section 1.513-1(d)(2) of the regulations generally provides that trade or business is 'related' to exempt purposes only where the conduct of the business activities has causal relationship to the achievement of exempt purposes (other than through the production of income); and it is 'substantially related' only if the causal relationship is a substantial one. Thus, for the conduct of trade or business to be substantially related to the purposes for which exemption is granted, the production of goods or the performance of the services involved must contribute importantly to the accomplishment of these purposes.

'The buildings that the organization acquired through the assumption of outstanding mortgages and leased after restoration may constitute 'debt-financed property' within the meaning of section 514(b)(1) of the Code since such property is held to produce income and is subject to acquisition indebtedness. Thus, it is necessary to determine whether substantially all of the use of the buildings is substantially related to the organization's exempt purpose, and therefore excluded from the definition of debt-financed property under the provisions of section 514(b)(1)(A)(i).

'The organization's educational purpose is carried on by acquiring, restoring, and preserving historically and architecturally significant buildings and making such buildings available for public viewing in a manner similar to a museum. The leasing of buildings under the circumstances presented bears no relationship to the historic or architectural significance of the buildings and neither accommodates nor encourages viewing by the general public. This leasing does not contribute importantly to the accomplishment of the organization's educational purpose and has no causal relationship to the achievement of that purpose (aside from the need of the organization for income). Thus, substantially all the use of the buildings is not substantially related to the organization's exempt purposes. Accordingly, the leased buildings constitute 'debt-financed property' within the meaning of section 514(b)(1) of the Code.